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A need to reconnect

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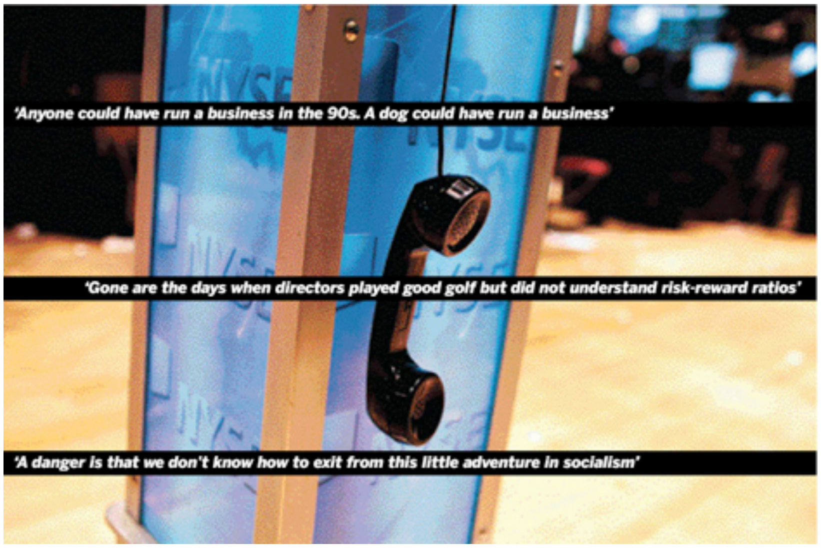

In different times, the offer from the check-in attendant would have been accepted with alacrity. But in the midst of the worst economic downturn since the Great Depression, with an angry public, populist politicians and an aggressive press baying for a crackdown on Wall Street's "excesses", the senior banker paused for thought when he heard those usually welcome airline words: "Sir, you have been upgraded to first class. Please follow me."

Finally replying, "I am fine in coach, thank you", he gave up the better seat and opened another chink in the armour of beliefs and practices that corporate America had built and spread around the world over decades.

Once hailed as examples of an American dream that rewarded success with large pay cheques, lavish perks and popular admiration, executives and their companies have been caught in the grip of a storm that will revolutionise business. The deep freeze of capital markets, the implosion of financial groups and the resulting rise in governments' sway over the private sector have called into question some of the foundations of Anglo-Saxon capitalism.

Long-held tenets of corporate faith – the pursuit of shareholder value, the use of stock options to motivate employees and a light regulatory touch allied with board oversight of management – are being blamed for the turmoil and look likely to be overhauled. "We are in uncharted waters," says Jack Welch, the former **General Electric** boss who embodied an era when the untrammelled interplay of market forces, domineering chief executives and the laser-like focus on quarterly earnings rises reigned supreme.

If, as it has become painfully apparent, the value system and operating principles that informed the corporate psyche since at least the end of the cold war were found wanting, what should replace them?

Business leaders are by instinct glass-half-full type of people but, this time, few believe their companies' future lies in their own hands. The financial sector's role in causing the shocks that have jolted the world economy has had a big side-effect: the debate on the future of corporate governance is no longer confined to the boardroom. Stakeholders ranging from trade unions to activist investors and government itself are claiming the right to draw the boundaries of a new corporate order. In the words of one union leader: "The time for corporate dictatorships is over. This is our time."

EUROPEAN INDUSTRY:

'I hope some of the lecturing will die down now'

European business got through previous crises with a mixture of restructuring, denial and government intervention, writes ***Richard Milne***. A similar outcome seems likely from this crisis even if the speed and scale of the downturn are testing companies as never before.

Take German private engineering companies, renowned for conservatism, which even in the middle of last year were bullish and saw their orders rising by 2 per cent. By November the monthly growth was minus 30 per cent; by January minus 42 per cent. Now, the groups are cutting jobs, investment and fighting for survival – as they are across Europe.

For many big European companies, the most significant event in the last decade was the shift in ownership from governments or other national companies to private, often foreign, shareholders. This has seen a big rise in stakes held by US and UK investors, leading in turn to a broad push for more "Anglo-Saxon" corporate policies, as many continental Europeans call them.

According to Gerhard Cromme, chairman of Siemens, foreign capital "revolutionised the way Germans do business". Across Europe, companies were forced to adopt more shareholder-friendly strategies and boards came under pressure over corporate governance issues, prompting investor revolts at the likes of Eurotunnel, the channel tunnel operator, and Deutsche Börse, Germany's stock exchange. Financing arrangements changed as local lenders proved less willing to prop up domestic groups and foreign banks flooded in.

How much of that is now likely to be rolled back? Already – as in most parts of the world – the state is more active, both in taking stakes in companies and prodding them to do what the authorities would like, such as a French suggestion that carmakers should close no domestic factories. Foreign lenders have withdrawn from many countries and banks are being encouraged to lend locally again.

Restructuring is likely to be a dominant theme, with

Such pressure, combined with an internal reassessment of companies' priorities precipitated by the crisis, is starting to crumble one of the cornerstones of the previous corporate edifice: the cult of shareholder value.

Since Mr Welch made the concept famous in a speech at New York's Pierre Hotel in 1981, the short-term goal of rewarding shareholders by increasing profits and dividends every quarter has become a mantra for companies around the world. With the share price of GE and other shareholder-focused companies soaring, executives from all over the world took up the credo Alfred Rappaport spelt out in his 1986 book, *Creating Shareholder Value*: "The ultimate test of corporate strategy, the only reliable measure, is whether it creates economic value for shareholders."

Fund managers encouraged this attitude, as pressure from their own quarterly reviews addicted them to the periodic improvements in earnings and stock prices promised by the prophets of shareholder value.

Today, that focus on the here and now is seen as a root cause of the world's economic predicament. "Immediate shareholder value maximisation, by itself, was always too short-term in nature," says Jeffrey Sonnenfeld at Yale School of Management. "It created a fleeting illusion of value creation by emphasising immediate goals over long-term strategies." Even Mr Welch argues that focusing solely on quarterly profit increases was "**the dumbest idea in the world**". "Shareholder value is a result, not a strategy," he says. "Your main constituencies are your employees, your customers and your products."

Like many other business figures, Mr Welch wants the task of charting a new course away from short-termism to fall to directors and executives. But unions, regulators and government authorities argue that a drive for change led by the same corporate elite that helped bring about the turmoil would not remove the contradictions that undermined the previous regime. "We don't feel companies should be run in the interest of short-term investors and executives who are hell-bent on making a killing regardless of the risks and leave taxpayers and real long-term holders to pick up the pieces," says Damon Silvers at the AFL-CIO, the US union federation.

Unions and "socially responsible" investors argue that the focus on short-term profits should be replaced not just by long-term strategic thinking but also by attention to issues such as the environment and the needs of customers and suppliers. The corporate social responsibility movement, on the rise before the crisis, is likely to receive fresh impetus from an investor recognition that companies' narrow search for profits was not always the best strategy.

Many business leaders object to what they regard as the growing encroachment by the state and other interest groups on their ability to run the company. "If there is a danger in the current situation, it is that we don't know how to exit from this little adventure in socialism so that the private sector can do what it does best – which is to innovate, grow and create job," says John Castellani, president of the Business Roundtable, the lobby group for some of America's largest companies.

But the arrival of President Barack Obama at the White House on the heels of a Democratic majority in Congress has, coupled with increased public antipathy towards plutocrats, already resulted in big wins for unions and other campaigners. Reforms that activist investors had demanded for years without much success, such as an (albeit non-binding) annual vote on executive pay, have already been approved by Congress. Others such as "proxy access" – the right for shareholders to nominate candidates to the board and vote down underperforming directors – are on the way, while the bonus caps imposed on the banks that took government funds have sent chills down many an executive spine.

These moves give campaigners new ammunition in the first big battle to reshape the rules of the business game: executive compensation. The failure of Wall Street's high-risk, high-reward model is set to bring about change on two main fronts: top management's pay and the use of stock options.

After years of soaring pay, business chieftains in America can expect to reap relatively meagre rewards in the coming years. As the downturn moved from Wall millions of jobs to be cut as profits slide. The question is how radical that restructuring will be. Although the automotive industry may be prime among those needing a shake-out, government support could stymie that. "I am worried that a lesson could be just that 'you are too big to fail', like Opel [General Motors' European arm], rather than 'you are too good to fail'," says a director of one carmaker. But big names will still disappear across the continent, as Woolworths has from UK retailing.

Strategy will be made with an eye not just on shareholders but also on what governments and workers want. Wendelin Wiedeking, chief executive of Germany's Porsche, hopes the days of shareholders seeking to tell companies what to do are over: "Nobody's system is perfect but hopefully some of the lecturing will die down now."

The UK is also showing signs of a change. Jeremy Darroch, chief executive of BSkyB, the broadcaster controlled by Rupert Murdoch's News Corporation, accepts that short-term financial return is not all. In almost continental European terms, he adds: "I think that means having a focus on our customers, it means having a focus on our employees and it means having a focus on the broader stakeholder groups."

Corporate governance improvements could, however, be reversed. "There is a danger that corporate governance slips down the agenda," says Hans Hirt of Hermes, the influential UK investor. Others fret that state intervention could slow the internationalisation of boards that Europe needs, leading instead to more national appointees.

Hubertus von Grünberg, chairman of ABB, the Swiss industrial group, fears a time of "Eurosclerosis" in which businesses muddle through rather than reinvent themselves. "Europe,

Street to Main Street, even companies that have not received federal aid, such as GE, **FedEx** and **Motorola**, have joined those on government life support in slashing top executives' compensation.

Many are also re-examining the gap in pay between executives and other employees. In America, the discrepancy between the compensation of those at the top of the corporate tree and those further down the trunk has grown steadily for decades, reaching an estimated 275 times the average in 2007 and contributing to rising wealth inequality in the country.

A significant portion of the blame for rocketing executive remuneration and managers' obsession with short-term goals is being pinned on stock options and other forms of incentive pay. Hitherto praised as a tool to align executive compensation with shareholders' gains, options have been increasingly discredited for rewarding executives for stock market rises that have nothing to do with them. In banking, end-of-year awards of options and stock had the added drawback of remunerating staff well before the company or its shareholders could find out whether their bets had paid off.

Several banks have announced plans to claw back future bonuses from employees whose deals sour in later years. But the fallout from what one executive calls "an era of rewarding ourselves with other people's money" will be felt beyond the financial sector. Regulators and investors look certain to strengthen the link between pay and long-term performance by introducing measures such as a ban on the sale of shares and options until after retirement, or even a straight pay cap.

Fred Smith, the founder and chief executive of FedEx, spoke for many corporate leaders in December when he predicted: "Some of the fantastic outsized gains that were offensive to people will be increasingly less likely. At board level ... things will not be looked at as costless to the shareholders."

Boards themselves will be in the line of fire. The losses suffered by financial groups have exposed the belief that directors were the knowledgable guardians of shareholders' interests as a fallacy – one that will not be lost on angry investors and fee-hungry lawyers. As a result, the composition of boards is likely to change dramatically.

Russell Reynolds, the doyen of American headhunters, says directors will have to be both more knowledgeable and more selfless. "Gone are the days when directors played a good game of golf but did not understand the risk-reward ratio of the business," he says. "And yet the current environment calls for people who can devote time to the business for relatively little pay. It is almost a charitable act."

Investors such as Bob Pozen, who runs MFS Investment Management, believe that listed companies' boards should become more like their private equity-owned rivals: smaller, nimbler and more competent. "The directors on those boards have the expertise, the time and the incentive to fully understand the company's issues," he says.

Jeffrey Immelt, who has presided over a fall of about three-quarters in the price of GE's shares since succeeding Mr Welch in 2001 and this week saw the removal of its triple A **credit rating** by Standard & Poor's, recently lamented: "Anybody could run a business in the 1990s. A dog could have run a business."

Unfortunately for Mr Immelt and his contemporaries, these are not the 1990s and nor are they like the several years that followed. As business structures that were thought to be indestructible collapse in the meltdown, the corporate sector will have to give up a lot more than first-class seats.

Additional reporting by Justin Baer

instead of finding something new to get out of the crisis like the US and Asia will do, could in fact go backwards."